

Situation of Pork Production in Quebec

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■ Evolution of Pork Production in Quebec

The pork industry is of great importance to Quebec's agricultural economy. In 2002 pork production in Quebec represented 31% of Canadian production. Canadian pork production has increased by 82% since 1981, while Quebec's pork production saw an increase of 56%; Quebec's portion of overall Canadian production is shrinking. Western provinces have seen great progress and a growth in production of 185% since 1981.

Table 1. Economic evolution of pork production in Quebec

	1994	2000	2001	2002
Production volume (millions of head)	4.8	6.8	7.0	7.4
Farm value, millions of \$	633	1033	1 155	949
Export Value, millions of \$	278	668	829	835
Number of jobs both direct & indirect	24 000	29 500	29 500	28 700
Economic Returns, billions of \$	2.4	3.7	3.7	3.2

Source: AGEKO: The economic impact of the growth of the pork industry in Quebec (Impact économique de la croissance de l'industrie porcine au Québec)

Table 2. The Evolution of Canadian Pork Production by Province 1981 to 2002

Year	Alberta	SK	Manitoba	Ontario	Quebec	Canada	% Quebec/Canada
1981	1 604 708	662 118	1 194 889	4 065 249	4 735 753	13 112 265	36%
1982	1 529 065	596 160	1 214 696	4 273 610	4 602 078	13 098 226	35%
1983	1 614 010	604 563	1 310 694	4 472 178	4 504 298	13 453 335	33%
1984	1 803 503	825 136	1 609 248	4 612 817	4 642 936	14 491 177	32%
1985	2 021 926	796 908	1 755 022	4 607 058	4 676 108	14 835 252	32%
1986	1 871 980	752 644	1 705 650	4 401 554	4 566 862	14 238 059	32%
1987	2 003 976	821 475	1 769 027	4 448 288	4 556 512	14 492 849	31%
1988	2 091 529	1 103 797	2 047 344	4 660 830	4 677 869	15 526 917	30%
1989	2 130 988	1 165 579	2 135 055	4 421 249	4 763 141	15 578 035	31%
1990	2 233 346	977 650	1 913 128	4 119 633	4 658 373	14 799 423	31%
1991	2 184 078	1 005 986	2 025 425	3 988 924	4 550 113	14 614 157	31%
1992	2 541 818	1 071 677	2 178 734	4 304 918	4 648 049	15 574 675	30%
1993	2 437 838	1 057 386	2 229 760	4 086 672	4 711 398	15 338 443	31%
1994	2 574 376	1 103 178	2 318 555	4 124 272	4 791 946	15 760 935	30%
1995	2 801 089	1 073 830	2 515 914	4 318 329	5 079 992	16 647 856	31%
1996	2 656 964	1 053 745	2 710 063	4 296 753	5 396 309	16 971 667	32%
1997	2 582 308	972 813	2 823 275	4 427 814	5 701 364	17 365 747	33%
1998	2 412 237	1 024 953	3 626 901	5 035 968	6 326 999	19 354 249	33%
1999	3 203 156	1 096 171	3 500 512	5 323 515	6 714 600	20 776 566	32%
2000	3 461 969	1 123 893	3 986 556	5 232 332	6 782 031	21 484 768	32%
2001	3 620 060	1 297 206	4 311 257	5 425 482	7 049 573	22 634 898	31%
2002	3 794 058	1 530 734	4 552 217	5 733 662	7 368 616	23 904 732	31%

Includes live and slaughtered animals shipped to the United States, Sources: Agriculture and Agrifood Canada, Annual Livestock & Meat Report, 1981 to 2002

Following a June 2002 moratorium on the development of the pork industry in Quebec, no new hog farms were authorized. A report issued in September 2003 by Quebec's Bureau of public hearings on the environment (Bureau d'audiences publiques sur l'environnement (BAPE)) recommends prolonging the moratorium until 2005. Considering the environmental difficulties faced in Quebec and the associated costs, we predict a very weak growth in Quebec's pork production over the mid-term.

Situation of the Quebec Markets

The 2000 and 2001 production years were very profitable. Since November 2001, market price has been below the cost of production. The financial situation of many hog operations is tight, more specifically:

- Farms that have a cost of production that is higher than the stabilisation model. A 2001 study published by the agricultural council groups of Quebec (Groupes Conseils agricoles du Québec), shows that the best operations (25% with the best results) have production costs of \$16.75 per head less than those operations at the opposite end of the spectrum (25% with the worst results);
- Operations that had problems with PRRS (porcine reproductive and respiratory syndrome);
- Operations that had not protected their working capital over the period of favourable prices (2000-2001);
- Farms that underwent expansion and were at full production when hog prices were falling.

Despite the difficult situation in the hog markets since 2001 and the deterioration of the financial situation of certain producers, we remain confident that the vast majority of operations will survive the current crisis.

■ Primary Methods of Financing Pork Production

Table 3. Methods of Financing

Characteristic	Debt	“Quasi-equity” (Debenture)	Equity (Capital)
Cost	Low (5-10%)	Medium (10-15%)	High (+15%)
Short-term reimbursement	Yes	Yes/No	No
Access to additional funds	Limited	Variable	Facilitated
Strategic support	Limited	Present	Clearly present

Source: Capital Financière Agricole.

Financing using debt is still the most often used and most economical method of financing. Financing using equity is an interesting option as it does not require short-term repayment of the debt, however the required return is over 15%, and there are very few agricultural endeavours that are capable of achieving such a return. In Quebec venture capital for agricultural endeavours

is for all intents and purposes non-existent. Some venture capital funds (SGF-Soquia, Fonds de solidarité FTQ) are available for food processing activities.

Considering how difficult it is to raise venture capital and “quasi-equity” funds on the market, support from the banking industry remains essential to the maintenance and development of the pork industry.

■ **Bank Financing and the Pork Industry**

Banks want to spread out their risk by diversifying their portfolios across many different industrial sectors. Agriculture is a large industry sector where the level of risk is generally considered to be moderate. At present banks remain interested in financing agriculture.

In this section I will introduce the vision of the National Bank of Canada, a lender primarily concentrated in Quebec with respect to the financing of the pork industry. 30% of the agricultural portfolio of the National Bank of Canada is invested in the pork industry. It is an area in which the bank has been active for over 25 years and where the quality of the portfolio is relatively good.

We believe that:

- Canada still has comparative advantages in pork production: breeding productivity, cost of feed, and product quality.
- Even though the global demand for pork is growing, competition (from the United States, Brazil, and Denmark) on the export markets will remain strong. Our heavy dependence on export forces our exporters to differentiate themselves in the markets.
- In Quebec, costs related to the environment are increasing.
- To be successful in pork production it is absolutely necessary to be a very efficient producer, and a competent administrator.
- Despite a more and more integrated North-American industry, the hog markets remain volatile and difficult to predict.

In summary, the industry faces a number of challenges, and the quality of pork from Quebec and the rest of Canada is no longer sufficient to ensure us a place in the export markets.

Historically, according to our experience in Quebec, our client pork producers, processors, and exporters have overcome these challenges. Over the years the industry has given itself such tools as: industry coordinating groups, the Quebec centre for pork development (le Centre de Développement du Porc du Québec(CDPQ)), and revenue support programmes of the agricultural financier

of Quebec (la Financière Agricole du Québec). The industry coordinating and consultation approach is not always easy, but a better network and the creation of new synergies in the industry are essential to overcoming the challenges that we face.

The Primary Risks Associated with the Pork Industry:

- Market risk: High variability of prices, variability of feed costs which represents the largest expense, Canada's competitive advantage in export markets, quality and differentiation of product and customer satisfaction, fluctuation of the value of the \$CAN, and Country of Origin Labelling (COOL);
- Management risk: qualifications and abilities of the administrators, ability to adapt to changes, quality of relief and transition plan;
- Production risk: maintenance of an elevated level of productivity and sanitation,
- Environmental risks: rising environmental costs, image of the industry (in Quebec the BAPE report)
- Financial risks: capitalization of enterprises, management of working capital, maintenance of a solid financial structure to face drops in market prices.

■ How Lending Institutions Evaluate the Risk Level of a Project for a Pork Production Enterprise

In this section I will present the main criteria used by financial institutions when analysing such projects. These criteria vary from one bank to another, but the approach used is more or less the same. I will also discuss the points producers should emphasize in their business plans.

At the National Bank of Canada, a risk rating is attributed to each enterprise based on the information found in the annual financial statements. For a new operation the risk rating is based on the opening balance sheet and realistic financial predictions.

The decision to finance a project, and the rate, take into account the risk rating associated with each enterprise. At the National Bank of Canada, the financial ratios and non-financial criteria that follow, are used to evaluate the risk rating:

- Reimbursement capacity ratio
- Management quality

- Net value to asset ratio
- Working capital ratio
- Market risk

Reimbursement Capacity (30% of the weighting)

The capacity to reimburse is the main decision factor to authorize financing. If your enterprise's capacity to reimburse has historically been poor, banks will refuse to finance the project, even if there are sufficient guarantees. At full operation, a debt coverage ratio higher than 1.30 is sought.

As revenues and profits in pork production are quite variable from one year to the next the ratio of debt coverage is calculated based on a 3-year average. In the case of a start up, the ratio of debt coverage is calculated based on predictions from the business plan for the year that the enterprise will be at full operation according to conservative price levels and costs.

The ratio of debt coverage is the most important element to pay attention to. In the business plans of pork production projects all elements that can lower the risk must be considered. For example: turn key construction contracts, selection of recognized technology, and an association with proven partners. Distribution agreements with processors and integration contracts with financially stable enterprises also allow the reduction of market risk.

In order to maintain a good reimbursement capacity and to build working capital it is preferable to finance long-term assets and improvements over their lifetime. Too often entrepreneurs finance their investments on too short a term, which contributes to reducing the debt coverage ratio.

Management Quality (20% of the the weighting)

The evaluation of management quality is attributed as a function of:

- Qualifications and competences of the entrepreneurs
- The integrity of the administrators
- Experience in production
- Breeding performance
- Training
- Use of management tools

The management quality is the second most important element in the decision process. In choosing partners (in genetics, in feed supply, veterinarians, public

accountants, etc.) who are leaders in the industry, you will increase your chances for success.

Net Asset Ratio (20% of the weighting)

A net value to asset ratio of at least 35% is sought. The assets are evaluated at market value.

Considering the high level of capitalization of pork enterprises and the wide variability of profits, enterprises should aim for an asset ratio above 50%.

Working capital ratio (15% of the weighting)

A working capital ratio higher than 1.25 is sought. The financially stable pork enterprises have a working capital ratio of more than 1.50 to 1.

Asset management is an element that too many enterprises neglect. In periods of high prices it is vital to build a safety net to help face periods when prices are below the cost of production, and take advantage of opportunities that the market offers in these periods. A good working capital will allow one to overcome drops in productivity associated with disease in livestock, which is a problem that we face on a regular basis in Quebec.

Market Risk (15% of the weighting)

Each agricultural production brings with it a different level of risk. For example, the level of loss on loans and the variability of profits of dairy and poultry enterprises was low over the last few years.

Other sectors bring with them more risks: for example greenhouse production and horticultural production in Quebec.

Different agricultural support programmes allow risk reduction in certain sectors.

Despite the difficulties of the industry and the losses felt by pork producers over the last 2 years, the National Bank of Canada considers that pork production represents a moderate market risk.

■ Conclusion

Pork production is a cyclical industry, in which the cycles are becoming less and less predictable, it is as important for the producer as for the banker to have a mid-term vision of the industry and the enterprise.

The Canadian and Quebec industries have a number of challenges to overcome to maintain their places on the domestic markets as well as the export markets.

In a period of good profitability it is important to build good working capital and not to overload the enterprise with non-productive investments.

In periods of low prices it can be strategically worthwhile to take advantage of certain opportunities that the market offers: the acquisition of an enterprise at a low cost, and expansion projects.

Production cost reducing investments and changes to improve performance in the herd should be realized in a depressed market in order to be at full production when prices improve.